August 2020

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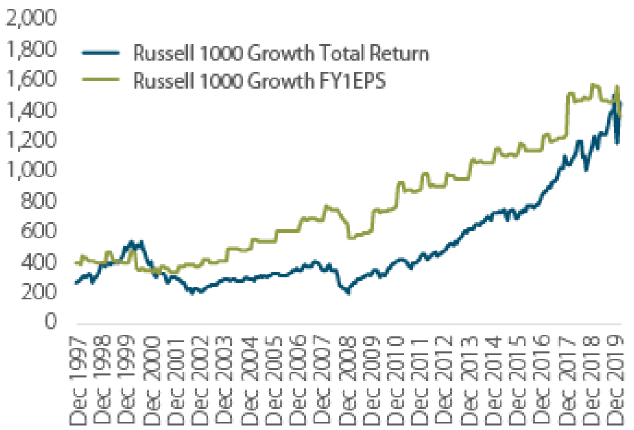
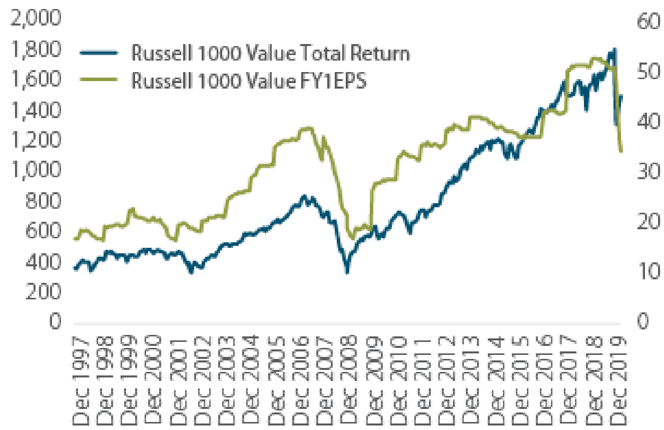
The Importance of Profit Growth in Equity Returns

There is frequent debate among market participants about which style factors will be in favor in the future: growth, value, momentum, active, passive, etc. While it is not possible to pinpoint the timing of when one style may be in favor over another, the Artisan Partners Growth Team (Growth team) believe the key element in determining the future path of a share price over the duration of an economic cycle is highly dependent on knowing which way profits are headed. To achieve this, the Growth team conduct rigorous, bottom-up fundamental analysis for each prospective and existing holding within the portfolio. Herein, a deeper dive is provided into the empirical evidence supporting the Growth team's core belief: stocks follow profits.

Equity share prices and forward profit expectations are nearly perfectly correlated. Examining Russell 1000 Index returns dating back to 1997, the paths of prices and EPS have an approximately 0.90 correlation. The relationship is slightly stronger for value stocks, with 0.92 correlation.

Exhibit 1: Russell 1000 Growth and Russell 1000 Value Indices Total Returns vs FY1 EPS



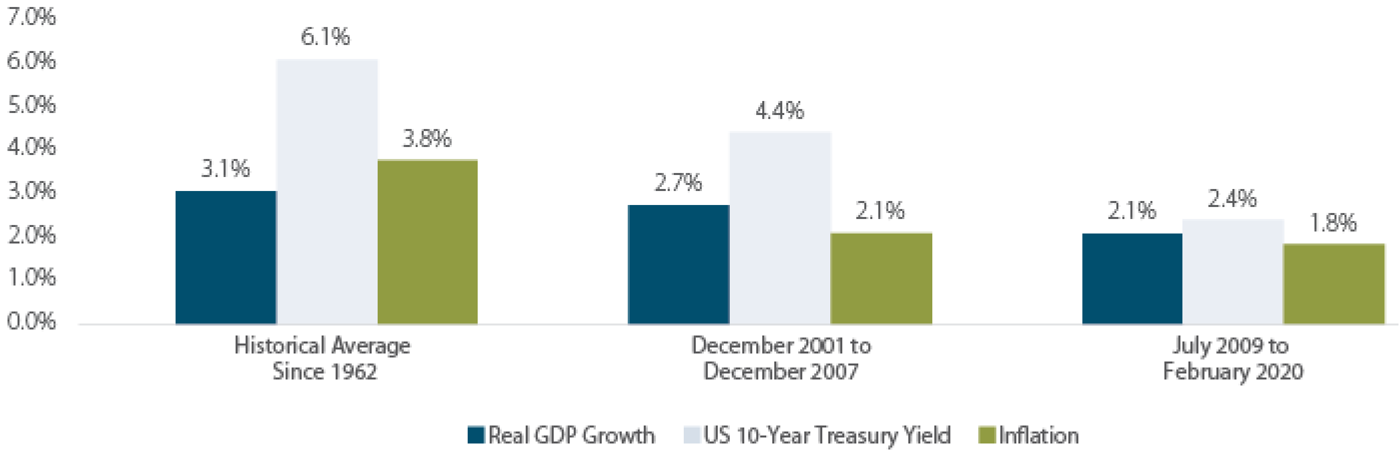


Sources: FactSet, Artisan Partners. Past performance is not indicative of future results.

The roaring economic growth of the 1990s came to a halt in the early 2000s amid the burst of the dot-com bubble and 9/11. The economic expansion that followed was marked by rapid globalisation, financial deregulation, tax cuts and below-average interest rates. GDP growth was just shy of 3%, and inflation ran just above 2%. More cyclical sectors —energy, materials, producer durables—realized higher rates of return, and value stocks fared better than growth.

The most recent economic expansion—history's longest, spanning nearly 11 years—was characterized by a tepid macro environment, several secular trends causing significant disruption across many industries, and growth stocks' outperforming value stocks. The backdrop of quantitative easing, historically low interest rates, weak inflation and subdued GDP growth coupled with several technological breakthroughs—the shift to e-commerce, widespread adoption of mobile smart devices, video/television streaming, 4G, cloud computing, the development of a multitude of new drug therapies—has driven tremendous disruption and profit growth across several industries and aided growth's relative outperformance. This disruption has been particularly notable within the information technology, health care and consumer discretionary sectors.

Exhibit 2: Historical GDP growth, Interest Rates and Inflation

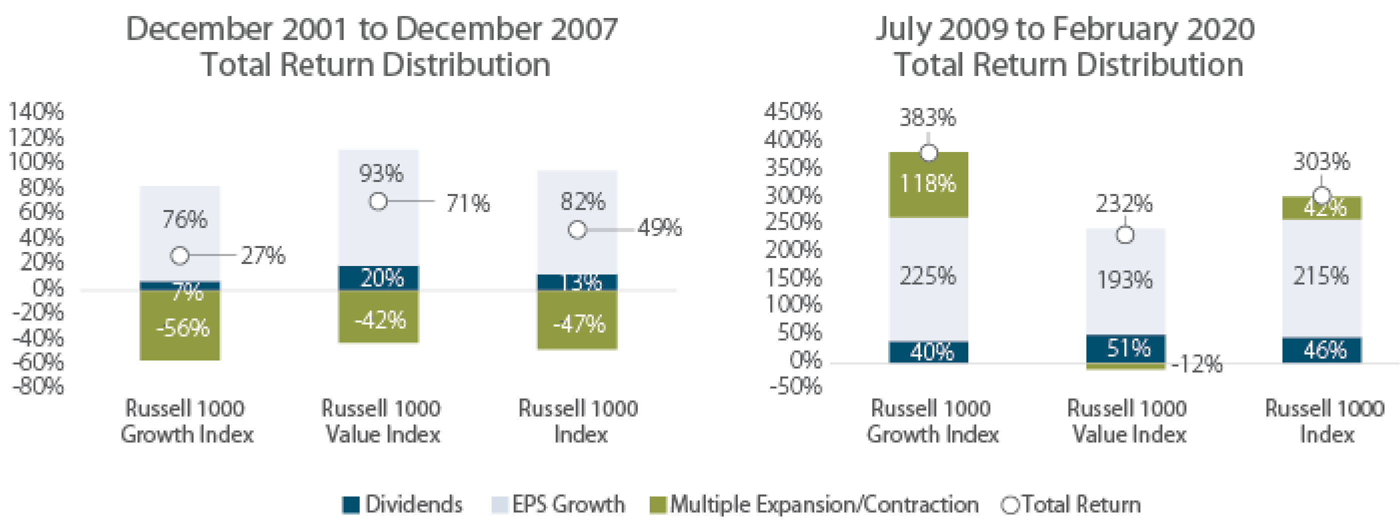


Sources: FactSet, Artisan Partners. Past performance is not indicative of future results.

Despite different environments, the largest driver of equity returns across the two previous economic expansions was profit growth. Examining Russell 1000 Growth and Russell 1000 Value Index returns from 2002 to 2007, multiple contraction undoubtedly played a meaningful role as the market was coming out of the dot-com bubble:-56% and -42% of the total return for growth and value, respectively. However, profit growth accounted for the majority of total return over this period: 76% and 93% for growth and value, respectively.

During the most recent economic cycle—July 2009 to February 2020—profit growth was again the largest contributor to total returns. While superior multiple expansion in growth stocks also played a role in the style's higher total return the Growth team believe this dynamic is attributable to the characteristics of growth stocks relative to value more so than systematic factors (i.e., historically low interest rates). Growth stocks exhibited higher levels of recurring revenue/ visibility, higher returns on equity, lower cyclicality, lower beta, higher margins and stronger free cash flow, and the Growth team believe the market appropriately rewarded these qualities over this timeframe.

Exhibit 3: Dividend, EPS Growth and Multiple Expansion/Contraction Contribution to Total Return



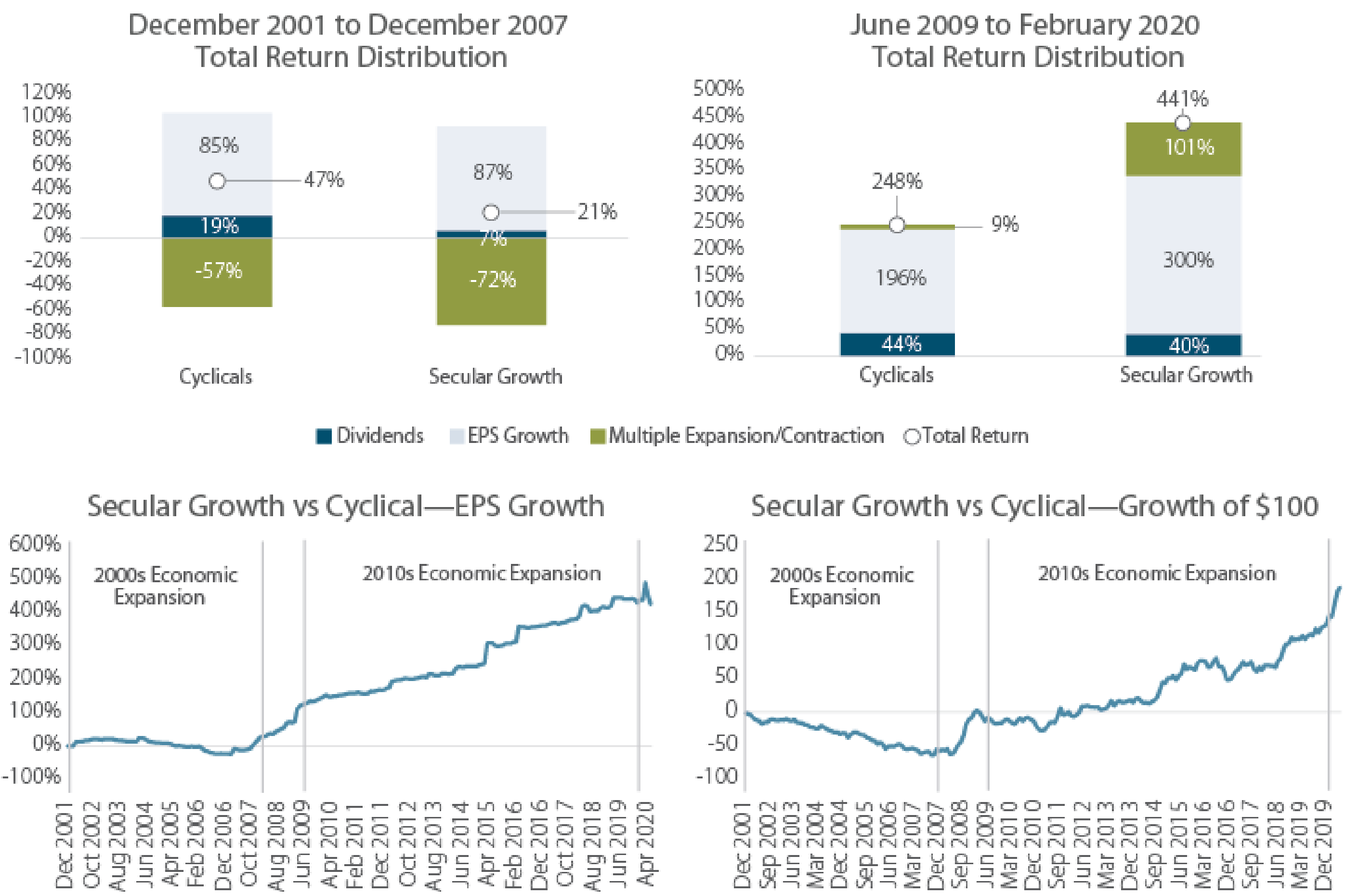
Sources: FactSet, Artisan Partners. Economic expansions are defined as the periods between the end date and start date of recessions. The two expansions occurred between 12/3/2001 to 12/31/2007 and 7/1/2009 to 2/29/2020 per FactSet. EPS growth is based on FY1 EPS during each respective period.

Exhibit 4: Growth Stocks' Rising Valuations Are Supported by Increasing Returns on Equity

Source: Cornerstone Macro. Past performance is not indicative of future results. Data as of 7/20/2020.

Profit growth has also been a key contributor to total returns for cyclical and secular growth stocks over the past two economic expansions. Nearly 90% of the total return for both segments during the 2000s economic expansion was driven by profit growth. While secular growth's absolute EPS growth slightly edged out cyclicals over this timeframe (119% versus 101%), the multiple contraction coming out of the dot-com bubble hit secular growth sectors the hardest. In the 2010s expansion, secular growth's total return has far exceeded that of cyclical, but the Growth team believe a key factor in this divergence has been secular growth's meaningfully higher rate of EPS growth (216% vs 167%).

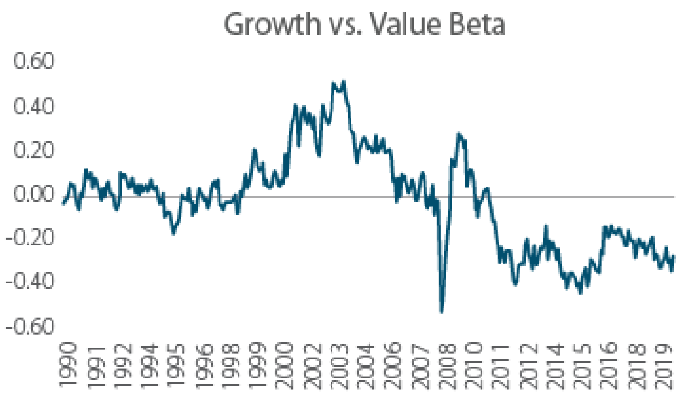
Exhibit 5: Cumulative Secular Growth and Cyclical EPS Growth

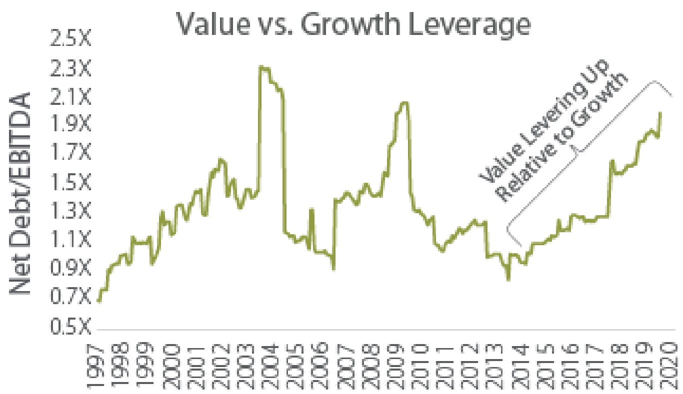


Sources: FactSet, Artisan Partners. Past performance is not indicative of future results. Sector data is based on Russell defined sectors. Cyclical sectors include financial Services, materials and processing and energy. Secular growth sectors include technology, consumer discretionary and healthcare.

Shorter-term market rotations can be tricky to predict, but the Growth team think a rally among cyclically depressed sectors is possible if there is a broad-based economic expansion—with rising inflation and interest rates—and progress toward developing a COVID-19 vaccine. These ingredients are considered necessary to sustain a strong value-over-growth rally—especially given value stocks (generally) have experienced increasingly higher betas relative to growth over the past decade. The Growth team think this may be too much to ask of the global economy, given extended fiscal deficits, US election uncertainty, mounting social discord and the damage done so far to personal and corporate balance sheets. Poor corporate balance sheets ultimately heighten risk and depress multiples, and rising leverage in value vs growth has been seen in recent years.

Exhibit 6





Sources: Cornerstone Macro, FactSet, Artisan Partners. Past performance is not indicative of future results. Represents the difference between the top and bottom quintile of stocks, ranked by PE (sector neutral) in the S&P 500 Index. Data represents Russell 1000 Value Index vs Russell 1000 Growth Index net debt/EBITDA.

In today's economy, the Growth team believe the market has been right to penalize more capital-intensive cyclical businesses with higher debt levels and reward high quality businesses with high levels of recurring revenue/visibility, lower cyclicality, lower beta, high margins, strong free cash flow and robust balance sheets. Over longer time-horizons, the Growth team believe these businesses will compound profits at rates high enough to support attractive equity returns . While further multiple expansion at this juncture would not be expected, it also would not be considered unjustified. As such, the Growth team believe high quality businesses whose long-term growth is not overly dependent on macroeconomic tailwinds and that are trading at valuations that can be understood will continue to do well.

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